

**Statement of
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U.S. Department of Housing and Urban Development
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Management and Performance Issues Facing HUD

Chairman Allard, Ranking Member Kerry, and other Subcommittee members, I appreciate the opportunity to appear before you today to discuss management and performance issues facing HUD. Specifically, I'd like to give you an overview of the HUD 2020 Management Reform initiative and discuss the findings in our March 12, 1999 audit of FHA's financial statements for the Fiscal Year ending September 30, 1998.

I had hoped that we could discuss the results of our audit of HUD's Consolidated Financial Statements this morning. Unfortunately, we are still awaiting the Department's comments on the draft audit and therefore do not have final audit results. A presentation of the FHA audit findings will be instructive, however, since FHA is such a critical subset of the overall HUD audit.

Overview of HUD 2020 Management Reform Initiative

HUD has been reforming itself for many years. Former Secretary Cisneros announced his Blueprint for Reinvention in 1994. Secretary Cisneros knew that HUD was extremely vulnerable as there were many discussions in the Congress about abolishing the Agency. Secretary Cisneros' proposed reforms were dramatic and sweeping. They included major program consolidations and

moving FHA out from HUD. A second part of his plan was to reduce HUD's staffing level to 7,500 by the year 2000. While there was no analytic basis for the 7,500 staffing level, given the sweeping program and legislative changes that were being proposed, the number may have been plausible if the reforms had been enacted. However, the Cisneros Blueprint ran on two tracks: the first was programmatic reform; the second was staff reductions. The first track was derailed as efforts to develop and implement new legislation were unsuccessful. The second track, the staffing reductions, continued moving forward.

By the time Secretary Cuomo took office in 1997, a clear lesson had been learned from the fate of the Reinvention Blueprint: legislative reforms at HUD would be extremely difficult to achieve, but reductions in HUD staffing were generally viewed favorably and could be accomplished with relative ease. Thus, Secretary Cuomo abandoned the programmatic reforms of the Reinvention Blueprint but held to the staffing reduction goal. In June 1997, Secretary Cuomo announced his HUD 2020 Management Reform Plan, which included the staffing reductions plus a series of complicated and far-reaching organizational and management process changes in HUD. Many of these changes were designed to address HUD management deficiencies that had been the subject of reports by the OIG and the GAO. The concept was, and still is, that HUD's overall performance will improve, despite continued staffing reductions, through correction of these management deficiencies. While the OIG has always supported the goals of HUD 2020, we noted that the details of the Plan were sketchy at best and the Plan was not supported by a realistic cost benefit analysis.

In order to use the buyout authority legislation that was expiring at the end of 1997, HUD moved quickly to reduce staffing. In the fall of 1997, HUD lost about 1,000 or better staff to

buyouts. These were predominantly experienced, journey level or better positions. The push at HUD was to bring down the numbers with little regard as to how that might impact on operations in the short or long term.

The HUD 2020 plan involved an entirely new organizational structure for HUD, and a staffing level of 7,500. Employees were required to apply for positions in this "new HUD." Late 1997 and early 1998 were troubling times for many HUD employees. After a colossal merit staffing process, some 1,300 to 1,400 employees found themselves without positions; and many other HUD staff changed jobs and/or locations during the merit staffing process. In the spring of 1998, the Secretary announced that HUD's target staffing level would be 9,100 until such time as HUD programs were consolidated and the public and assisted housing portfolios substantially improved. Unplaced staff were assigned positions in the "new HUD."

While the HUD 2020 organizational and staffing changes are generally complete, the management process changes that were to compensate for staffing reductions and bring increased efficiency and better performance are still very much a work in progress. For example:

Real Estate Assessment Center (REAC) Operations. The REAC, which is a cornerstone of HUD 2020, is expected to provide the Department the means to evaluate the overall condition of its public housing and multifamily portfolios, more than 30,000 properties. The REAC will use objective measures to determine the physical and financial conditions of these properties. Using sophisticated automated methods, properties will be scored and the Internet will be used to transmit data to HUD. Properties demonstrating a failing score will be targeted for intervention. While this process of scoring properties, based on

the physical and financial information, is far along in development, actual implementation and use of this process for monitoring may be a year or more away.

Troubled Agency Recovery Center (TARC) and Enforcement Center (EC) Operations.

The type of intervention for identified troubled projects will depend on whether the property is public housing or multifamily insured housing.

- Failing scores for Public Housing Agencies (PHAs) will result in referrals to a TARC either in Cleveland or Memphis. The TARC will be responsible for developing and implementing intervention strategies to help a troubled PHA perform at an acceptable level. If the PHA is making substantial progress after the first year, the PHA may be allowed to continue in the recovery effort an additional year. If the PHA has not achieved a passing score within 2 years, the recently enacted Quality Housing and Work Responsibility Act of 1998 requires that HUD place the PHA in judicial or administrative receivership.
- Multifamily projects with failing scores will be referred to the Enforcement Center (EC). Protocols defining relationships among the REAC, the Office of Housing, and the EC with respect to such properties are still under development.

Both the TARC and EC's future workloads are dependent on the full implementation of the REAC. Their current work includes various problem PHAs and Multifamily projects identified through old business methods.

Home Ownership Center (HOC) Operations. The concept of HOCs, started in the previous Administration, was made part of HUD 2020. The four HOCs (in Philadelphia,

Atlanta, Denver, and Santa Ana) have responsibility for the oversight of single family endorsements (800,000+ annually), management of Real Estate Owned (REO) (70,000+ annually), and servicing of Secretary held notes (12,000+). The staffing level for these HOCs was predicated on HUD's contracting out the management of REO and selling off the note portfolio. The Management and Marketing Contracts for REO will be in place later this month and there has been no action on the sale of the note portfolio. Meanwhile, the overwhelming workload has caused serious problems with the timely disposition and effective management of REO properties.

Section 8 Financial Management Center (FMC) Operations. Under HUD 2020, the FMC in Kansas City is to take responsibility for the budgeting, financial and payment functions for project-based section 8 assistance. It was thought that these type of routine processes (i.e., reviewing vouchers, renewing contracts, and processing rent increases) distracted Office of Housing field staff from performing their more important monitoring functions. Today, however, most Office of Housing field offices continue to perform these Section 8 duties. HUD has requested \$209 million for Contract Administrators in Fiscal Year 2000.

Community Builder Function. The Community Builder function is part of the Secretary's HUD 2020 goal of helping State and local governments, businesses and non-profit groups gain an understanding of and ability to utilize HUD programs. The Secretary refers to the Community Builders as part of a new "Urban Peace Corps." More than half of the soon to be 800+ Community Builders are being hired as two year term employees at high grade levels, between GS 13 and GS 15. The remaining staff are full-

time career Federal employees. It is intended that Community Builders will handle outreach efforts while the behind-the-scenes work of the Agency will be performed by Public Trust Officers. A Public Trust Officer in HUD is pretty much anyone who is not a Community Builder. Bringing in a cadre of high paid outsiders to be the experts in HUD programs has been the basis for much consternation among the many experienced program staff at HUD. Community Builder staff and Public Trust Officer staff are still in the process of sorting out their specific roles and responsibilities.

When HUD began its 2020 Reform changes in the fall of 1997, the OIG thought that the reforms were moving too fast. While the organizational framework for the new HUD was designed, the details behind the reforms were barely in the planning phase. Staff were hired for new positions in the agency that were still being defined. In some instances, we found that vacant positions in Centers were announced before HUD had determined where the Centers would be located. We issued a report in the fall of 1997 recommending that the Department delay the timeline for completing the reform effort and review the costs and benefits of the changes before the changes were made. Our concerns went unanswered.

HUD lost a significant number of staff in the fall of 1997. By early 1998, many of the positions in HUD's new organizational structure had been merit staffed and people were moving into them. In short, it was clear, in early 1998, that it was too late for HUD to turn back to the past ways of doing business. The OIG therefore changed its posture on HUD 2020, and urged that the management process reforms, needed to support and enable the organizational changes and staffing reductions, be implemented as quickly as possible.

Many of these management process reforms are still not operational and some are not projected to be operational for another year or so. In addition, implementation could be further delayed as we understand that PHA industry groups are now suing the Department over the new physical inspection standards. While delays are understandable given the magnitude and complexity of the HUD 2020 changes, it is clear from our recent audit work that these delays in fully implementing HUD 2020 are causing serious work overloads. Also, critical tasks, such as monitoring program recipients, are being deferred. In the last 6 months, our office has issued internal audits on the Empowerment Zone, Hope VI and Drug Elimination Programs. A common theme in each of these reviews was a lack of HUD program oversight. Moreover, our Fiscal Year 1998 KPMG's LLP FHA financial audit work confirms that weaknesses reported in prior reports continue to exist.

FHA Financial Audit Results

On March 12, 1999, we issued an unqualified opinion on the FHA financial statements for the period ending Fiscal Year 1998. This audit was performed by the independent certified public accounting firm KPMG LLP. This is first year that FHA has been able to prepare audited financial statements based on accounting standards applicable to federal agencies. This required extensive ad hoc efforts by Office of Housing and contractor support personnel as FHA's general ledger was not compliant with the U.S. Standard General Ledger. As a result, additional analysis was required to prepare both the financial statements and reports to the U.S. Treasury on budget execution. Also, keep in mind that the opinion on the financial statements represents only one part of a three part review of the financial condition of FHA. The Report on Internal Controls and the Department's Compliance with Laws and Regulations continue to report serious material

weaknesses and other problems which must be addressed before the Department will no longer be considered high risk. This audit confirms a series of long standing management problems to including: internal control weakness, unreliable financial management systems, organization deficiencies and an insufficient mix of staff with the proper skills.

Let me caution you about placing too much reliance on the opinion part of this report. The opinion section helps in answering the question, “How good a job is FHA doing in *accounting* for Federal expenditures?”. The more critical concern for the Congress and the American taxpayer should be, “How effective a job is FHA doing in assuring the proper outcomes from these expenditures?”. The report’s seven reportable conditions, including four which are material control weaknesses, focus on these outcome issues. They are an integral part of this report and illustrate how the Department is fulfilling its core mission. Let me briefly discuss some of the conditions that are addressed in this report.

- ***FHA must address staff and administrative resource issues.*** FHA must review the staffing levels, personnel skills versus skill needs, and training resources available to conduct its mortgage insurance programs. As implementation of the reorganization proceeds, these issues remain critical to the management of FHA’s programs.

Planned reductions in single family staffing levels were predicated on significant assumptions and programmatic changes, including streamlining or outsourcing REO property, selling single family Secretary-held notes, and consolidating single family functions into four Home Ownership Centers (HOC). While staffing reforms occurred under HUD 2020, programmatic reforms related to single family REO and note

operations did not keep pace, creating obstacles to the effective monitoring and servicing of FHA's portfolios during fiscal year 1998.

FHA's business related to its single family programs has changed significantly over the years. Improvements in automated technology and electronic data interchange have created efficiencies. Additionally, the single family Secretary-held notes inventory has decreased dramatically. However, the effort to service post-insurance portfolios, including single family property and notes, has drawn necessary resources away from focusing on the primary responsibility of program oversight and portfolio management, during a period when business volume has grown dramatically

- ***FHA must continue to place more emphasis on early warning and loss prevention for insured mortgages.*** FHA must focus more attention on reducing the frequency and loss severity of defaults on insured mortgages by improving its efforts to identify and cure troubled multifamily mortgages before they become seriously delinquent and by utilizing loss mitigation tools for the single family insured portfolio before properties are foreclosed.

Only 30 percent of troubled and potentially troubled projects tested during the audit had management reviews completed by FHA during the fiscal year. For financial statement reviews, unaudited data provided by the Office of Housing stated that less than 85 percent of financial statements submitted were reviewed; the standard is 100 percent. Only 26 percent of troubled and potentially troubled projects reviewed had physical inspections. Failure to monitor and manage the portfolio on a proactive basis

increases the risk of projects becoming troubled, thereby escalating the risk of future claims and placing additional stress on limited resources.

The number of seriously delinquent single family loans that are cured through borrower self-help and avoid foreclosure through relief measures provided by loss mitigation tools is increasing. The total number of loss mitigation interventions more than doubled between fiscal years 1997 and 1998, from 5,019 to 10,900. Based on the first quarter's activity, the fiscal year 1999 projection is 20,000 loss mitigation interventions. While FHA has made significant progress monitoring the insured single family portfolio, these initiatives are relatively new, several are still developing, and the benefits have not yet been fully recognized.

- ***FHA must improve federal basis and budgetary accounting.*** FHA must perform analysis and reconciliation of obligations to ensure that obligated amounts are properly stated. In addition, formal documentation must be developed to support the preparation of federal basis financial statements, budgetary standard forms, and FHA's cost allocation process. Furthermore, FHA's methodology for calculation of the liability for loan guarantees requires refinement.

At our request, FHA identified 194 contracts and approximately 1,300 purchase orders, which appeared to have been fulfilled, but not de-obligated. FHA de-obligated those contracts and purchase orders for a total adjustment to the financial statements of approximately \$29,700,000. Also at our request, FHA reconciled the commitments and endorsements in the accounting system to those in the budget system, and identified nine items, which had not been recorded in the budget system.

In addition, FHA identified errors in mortgage amounts and subsidy rates between the accounting and budget systems. As a result, FHA recorded \$7,500,000 in additional obligations in the budget system. Finally, FHA identified approximately \$6,900,000 of unrecorded unliquidated obligations related to contractor processed disbursements and adjusted the financial statements, accordingly.

- ***Information technology systems must be improved in order to support business processes more effectively.*** Improvements to FHA information systems are hindered because of the existence of other critical system priorities at HUD. Systems are not linked and integrated, or configured to meet all financial reporting requirements. Additionally, many of FHA's financial management systems do not share a common data architecture, and not all systems provide the appropriate case level detail required for credit reform compliance. FHA's inability to quickly develop or acquire more modern information technology will continue to deter its efforts to be a more efficient and effective housing credit provider. Until new information technology is implemented and available throughout the agency, FHA must collect data and develop information in less efficient ways. FHA must aggressively pursue system development, modernization, and improvement.

KPMG LLP also notes three other conditions regarding the need for FHA and HUD to:

- ***continue actions to quickly resolve Secretary-held mortgage notes and minimize additional mortgage note assignments and note servicing responsibilities.*** At September 30, 1998, FHA had approximately 12,000 single family notes with an outstanding balance of \$731 million. Although FHA has considerably reduced the

single family notes portfolio in recent years and is currently under contract with a special servicer who will assume the portfolio in April 1999, we noted the following weaknesses in fiscal year 1998: (1) an inability to consolidate servicing into one location; (2) restricted servicing efforts; and (3) shifts in the portfolio to substantially non-performing notes.

- ***sufficiently monitor and account for its single family property inventory.*** An aging of single family REO reveals that properties remained in inventory for longer periods of time. The average disposition lag time increased from 5.4 months during fiscal year 1997, to 6.6 months during fiscal year 1998, and continues to rise. The number of on-hand REO properties increased over 25 percent between fiscal year end 1997 and 1998. At some field offices, inventory more than doubled between fiscal year 1997 and 1998. Over 35 percent of the single family REO inventory exceeded standard processing times at fiscal year end 1998. Additionally, property loss rates based on FHA's acquisition cost increased significantly during fiscal year 1998. Finally, FHA is incurring additional costs as a result of increases in property disposition lag time, on-hand inventory, and property holding costs
- ***enhance the design and operation of information systems' general and application controls.*** FHA management must rely heavily on computerized information systems to process the large volume of data required for such a diverse insurance operation. These systems not only process accounting data for functions including insurance processing, servicing, and asset disposition, but for sensitive cash receipt and

disbursement transactions. Therefore, it is essential that FHA ensure a proper control environment to prevent errors and unauthorized access.

Conclusion

I think I can speak for everyone in the OIG in saying that we want to believe that HUD 2020 will work, and that HUD's program performance will improve as a result. But, in our judgment, HUD 2020 is not a sure thing. It ignores HUD's mission and programs to concentrate on organization and management processes. As demonstrated by the audit of FHA's 1998 financial statements, it builds on systems of internal control that have never been fully corrected. It was driven by staff reductions that had no rational basis.

Reinvention and reforms in the Federal Government are excruciatingly difficult. HUD administers many diverse programs, and HUD's Fiscal Year 2000 Budget requests additional programs/activities. For the most part, these programs are complex, competitive and lack market incentives. These type of programs require oversight on a continuing basis. In addition, HUD has a well established network of public interest groups that have a personal stake in the continuation of various programs that meet their needs. In such an environment, it is important that HUD have sufficient and competent staff to oversee these activities. Further, the centralized centerpieces of the Reform, the Real Estate Assessment Center and the Enforcement Center, are administrative creations that could easily be abandoned by a subsequent Secretary.

Most importantly, during the current transition period, until functions are properly staffed, policies and procedures are developed, and control weaknesses are corrected, HUD programs are

particularly vulnerable to fraud, waste, and abuse. I would urge continuing Congressional oversight to minimize those vulnerabilities.